

# ECONOMICS

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## Thinking Like an Economist

# The Economic Problem

✧ A household and an economy face many decisions:

- Who will work?
- What goods and how many of them should be produced?
- What resources should be used in production?
- How should it be produced using combinations of land, labour and capital?
- Who should get the goods and services produced?
- At what price should the goods be sold?

# The Economic Problem

✧ *Economics* is the study of how society manages its scarce resources.

✧ Resources mainly classified as:

- Land
- Labour
- Capital

# Scarcity and Choice

## ✧ Society and Scarce Resources:

- The management of society's resources is important because resources are scarce.
- *Scarcity*. . . means that society has limited resources and therefore cannot produce all the goods and services people wish to have.
- *Economics* is the study of how society manages its scarce resources.

# HOW PEOPLE MAKE DECISIONS?

✧ **‘The economy’** refers to all the production and exchange activities that take place every day - all the buying and selling.

✧ The economy exists at different scales

- Local
- National e.g. the UK
- International e.g. EU

# THE ECONOMIST AS POLICY ADVISOR

- ✧ When economists are trying to explain the world, they are scientists.
- ✧ When economists are trying to change the world, they are policy advisors.

# THE ECONOMIST AS A SCIENTIST

✧ The economic way of thinking . . .

- Involves thinking analytically and objectively.
- Makes use of the scientific method.

# ECONOMISTS AS DECISION MAKERS

- ✧ Economics could be said to be the science of decision-making.
- ✧ Economists identify costs and benefits of decisions.
- ✧ Economists attach values to the costs and benefits.
  - If the benefits outweigh the costs then the decision maybe warranted.
- ✧ Every day millions of decisions are made by individuals, businesses and governments. Some will be rational, but others will not.



# Economic Methodology

❖ Mainstream economics or neo-classical approach assumes that:

- Markets generate well-being.
- Decisions are based on rationality with agents acting in self-interest.

❖ Heterodox economics holds different view.

- Neo-classical assumptions on rationality are wrong.

# Heterodox Ekonomi

- ❖ Feminist economics makes the case for including unpaid work such as that carried out in the home.
- ❖ Marxist economics note the control and power that some have over production.
- ❖ Austrian school say markets should be allowed to work without government interference.

# The Scientific Method: Observation, Theory, and More Observation

- ❖ Uses abstract models to help explain how a complex, real world operates.
- ❖ Develops theories, collects, and analyses data to evaluate the theories.

# Empiricism

- ❖ Empirical information is gathered from:
  - Observation.
  - Experience.
  - Experiment.
- ❖ A hypothesis is an assumption.
- ❖ Scientific method tests the hypothesis
  - Inductive
  - Deductive

# Empiricism

## Inductive reasoning

- Refers to the process of observation from which patterns might be formed which provides evidence for a hypothesis which may lead to a theory.

## Deductive reasoning

- Begins with a theory from which a hypothesis is drawn. The hypothesis is then subject to observation and either confirmation or rejection.

Theories can be used to explain something and to make predictions.

- Things change, and old theories can be rejected and new theories come along.

# Empiricism or Rationalism?

- ✧ Rationalism is where 'truths' are established through reason and intellectual deduction rather than appealing to emotions or the senses.
- ✧ Empiricism asserts that knowledge is gained by real-world experience.
  - Empirical evidence derived from observation of data does have to be interpreted and this can lead to different conclusions being drawn.
  - It is important to separate cause and effect.
- ✧ Like many things in economics, there is no right answer to this question.
- ✧ Scientific methodology is now widely accepted as the direction for the subject.

# The Role of Assumptions

- ✧ Sometimes it is useful simplifying the real world. Economists make assumptions in order to make the world easier to understand.
  - Example: to understand international trade, it may be helpful to start out assuming that there are only two countries in the world producing only two goods.
  - Economists need to think about which assumptions are most helpful to make.
  - Once we understand the model we can begin to relax some assumptions.
- ✧ The art in scientific thinking is deciding which assumptions to make.
  - Economists use different assumptions to answer different questions.

# Experiments in Economics

- ✧ Economics is a science based on human behavior.
  - Uses abstract models to help explain how a complex, real world operates.
  - Uses data that already exists or can be collected.
  - Can use natural experiments e.g. observe the effects of a smoking ban or new speed limit on drivers.



# Models in Economics

- ✧ Economists use models to simplify reality in order to improve our understanding of the world.
- ✧ A model will contain a number of variables.
  - **Definition of an endogenous variable:** a variable whose value is determined within the model.
  - **Definition of an exogenous variable:** a variable whose value is determined outside the model.
  - Knowing about the variables helps separate cause and effect.

# Positive Versus Normative Analysis

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- ✧ *Positive statements* are statements that attempt to describe the world as it is.
  - Called descriptive analysis
- ✧ *Normative statements* are statements about how the world should be.
  - Called prescriptive analysis

# Positive Versus Normative Analysis

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## ✧ Positive or Normative Statements?

- An increase in the minimum wage will cause a decrease in employment among the least-skilled.

POSITIVE

- Higher federal budget deficits will cause interest rates to increase.

POSITIVE

# Positive Versus Normative Analysis

## ✧ Positive or Normative Statements?

- The income gains from a higher minimum wage are worth more than any slight reductions in employment.

NORMATIVE

- Governments should collect from tobacco companies the costs of treating smoking-related illnesses among the poor.

NORMATIVE

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NORMATIVE

# Why Economist Disagree

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- ✧ Economics is not a true science as it deals with human behavior.

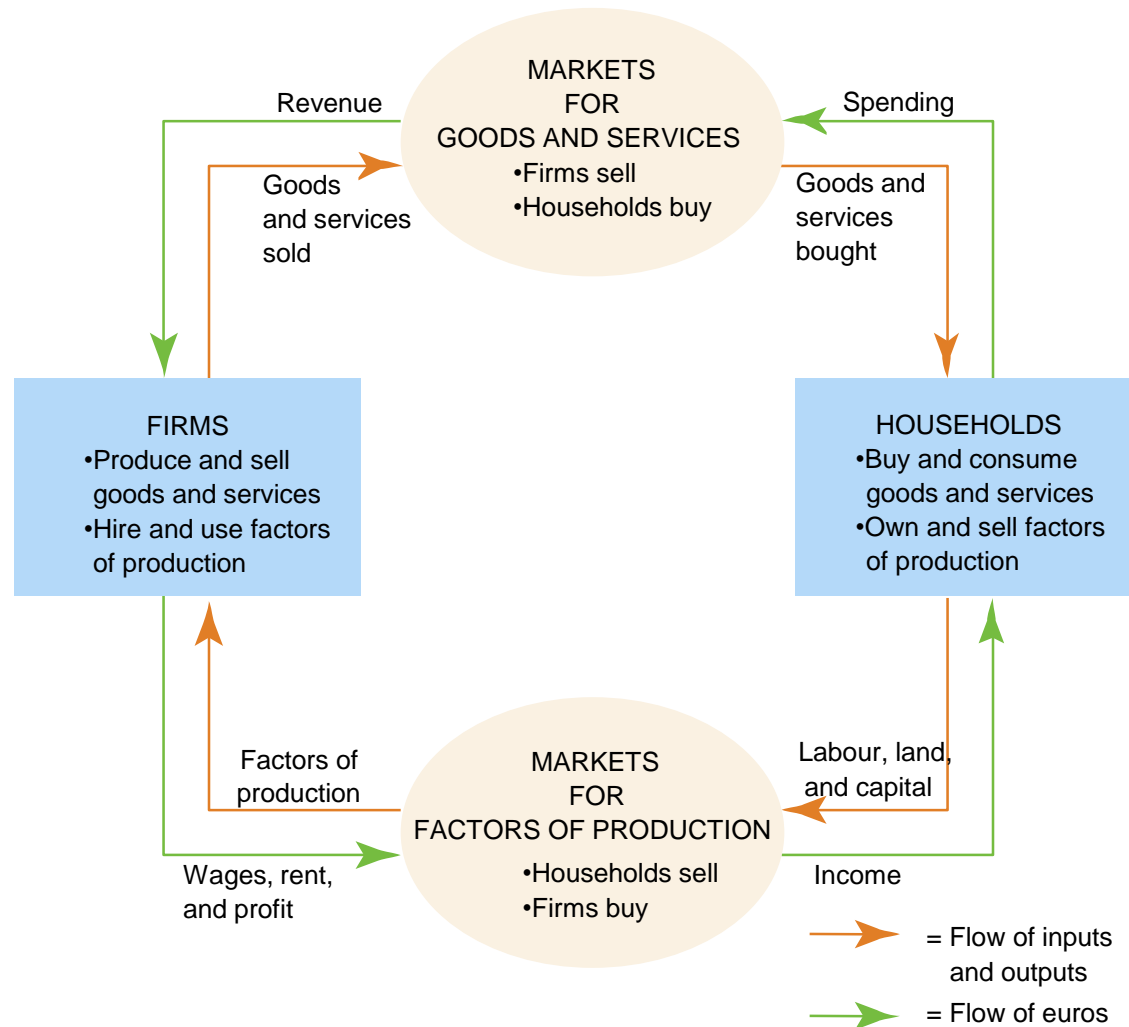
Economists may:

- ✧ Disagree about the validity of alternative positive theories about how the world works.
- ✧ Have different values and, therefore, different normative views about what policy should try to accomplish.

# Our First Model: The Circular-Flow Diagram

✧ The *circular-flow diagram* is a visual model of the economy that shows how Turkish Liras flow through markets among households and firms.

# Figure 1 The Circular Flow





# Our First Model: The Circular-Flow Diagram

## ✧ Firms

- Produce and sell goods and services
- Hire and use factors of production

## ✧ Households

- Buy and consume goods and services
- Own and sell factors of production

# Our First Model: The Circular-Flow Diagram

## ✧ Markets for Goods and Services

- Firms sell
- Households buy

## ✧ Markets for Factors of Production

- Households sell
- Firms buy

# Our First Model: The Circular-Flow Diagram

## ✧ Factors of Production

- Inputs used to produce goods and services
- Land, labour, and capital

# Ten Propositions about Which Most Economists Agree

## Proposition (and percentage of economists who agree)

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1. A ceiling on rents reduces the quantity and quality of housing available. (93%)
2. Tariffs and import quotas usually reduce general economic welfare. (93%)
3. Flexible and floating exchange rates offer an effective international monetary arrangement. (90%)
4. Fiscal policy (e.g., tax cut and/or government expenditure increase) has a significant stimulative impact on a less than fully employed economy. (90%)
5. If the federal budget is to be balanced, it should be done over the business cycle rather than yearly. (85%)
6. Cash payments increase the welfare of recipients to a greater degree than do transfers-in-kind of equal cash value. (84%)
7. A large federal budget deficit has an adverse effect on the economy. (83%)
8. A minimum wage increases unemployment among young and unskilled workers. (79%)
9. The government should restructure the welfare system along the lines of a "negative income tax." (79%)
10. Effluent taxes and marketable pollution permits represent a better approach to pollution control than imposition of pollution ceilings. (78%)

# Summary

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- ① Economists try to address their subjects with a scientist's objectivity.
  - They make appropriate assumptions and build simplified models in order to understand the world around them.
  - A simple economic model is the circular-flow diagram.
- ② A positive statement is an assertion about how the world is.
- ③ A normative statement is an assertion about how the world ought to be.

# Summary

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- ③ When economists make normative statements, they are acting more as policy advisors than scientists.
- ⑥ Economists who advise policy makers offer conflicting advice either because of differences in scientific judgments or because of differences in values.
- ⑦ At other times, economists are united in the advice they offer, but policy makers may choose to ignore it.